



Lessons of the Subprime Crisis
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ONE ASPECT of the subprime mortgage crisis that deserves special attention is that it was in large part a natural experiment on the role of regulation. And the results are clear: Reasonable regulation of mortgages by the bank and credit union regulators allowed the market to function in an efficient and constructive way, while mortgages made and sold in the unregulated sector led to the crisis.

At every step in the process, from loan origination through the use of exotic unsuitable mortgages to the sale of securities backed by those mortgages, the largely unregulated uninsured firms have created problems, while the regulated and FDIC-insured banks and savings institutions have not. To the extent that the system did work, it is because of prudential regulation and oversight. Where it was absent, the result was tragedy for hundreds of thousands of families who have lost, or soon will lose, their homes and for those who invested in shaky and untested, even though highly rated, securities, and have been forced to take large losses and, in many cases, shut their doors.

In the coming months, Congress needs to apply that lesson - to adopt for all of the mortgage industry, both origination and secondary market sales, the sort of rules that served us well in the regulated sector.

Beyond that, a second major aspect of the subprime crisis demands attention: the unanticipated impact it had on financial markets in general. Indeed, that lack of anticipation is a danger sign: None of the entities charged with supervision of the economy predicted that the crisis would have broader negative effects. And this leads to a second and more difficult task that the Financial Services Committee must undertake: examining whether or not in the broader financial markets we have the same pattern that we saw in the subprime market; namely, a massive increase in innovative financial activity that brings a good deal of benefit to society, but also poses serious dangers.

In part because of massive intervention by central banks the crisis that caused global capital markets to seize up in the first three weeks of August appears to have moderated - at least temporarily. However, it did not work as expected, and we must retool regulatory and oversight apparatus to ensure that we are not caught so woefully unprepared again.

Balance sheets are still full of lightly or never traded asset-based securities and derivatives that are difficult to value and have many of the same characteristics of the subprime based securities that plummeted in value when the real estate market turned lower.

Well-functioning financial markets depend on transparency and confidence that institutions are playing by clearly defined rules. Both were in short supply in the months leading up to the August meltdown and remain so today. Large pools of unregulated capital, often highly leveraged, especially in hedge and private equity funds remain opaque and have been joined by massive sovereign investment funds to transform the financial landscape in ways that are out of reach of regulators here at home and in other wealthy countries. We lack the information that we need to ensure safety and soundness as well as the confidence that comes from the requirements mandating governance and reporting standards that apply to publicly traded companies.

To an important extent these new pools of capital are structured in a fashion that allows them to avoid the scrutiny that is required of firms and financial institutions in the regulated sectors. We should not be surprised. It is a fact of life that investors and firms will seek to innovate their way around whatever regulatory strictures apply, whether they deal with health and safety, labor protections, or reporting obligations. This tendency has been exacerbated by a 30-year attack on the very notion of a regulatory role for governments and loud professions that the market not only knows best, but knows everything.

Our job is to understand the changes in the financial marketplace and consider what we must do to ensure that our regulatory system is able to keep up with those changes. Innovation is as important in financial markets as it is in product markets, but it would be foolish to act as if regulatory structures, designed for a different world, do not have to be as nimble and innovative as those they regulate.

As capital markets continue to become more globally integrated and complex, we must modernize our own regulatory tools; but it is certain that a truly 21st-century regulatory structure must include sophisticated multilateral initiatives as well. We must join with other countries to craft oversight and regulatory responses that are as global as the financial marketplace. A new race to the bottom by firms seeking to escape national regulation would not be good for any of us. An innovative global financial economy requires internationally coordinated financial regulation.

We may have dodged a bullet earlier this year, but that should cause us to redouble our efforts, not rest on our unearned laurels while the next crisis builds.